Identifying Different Types of Financial Statements

Michael Wildeveld, CEPA, M&AMI, CM&AP, CM&AA, CBI, CBB
michaelw@veldma.com

Veld Mergers & Acquisitions
www.veldma.com
1 Park Plaza, 600
Irvine, CA 92614
310-652-8066

In this issue, we will look at the different types of financial statements that exist, the costs associated with creating the statements and the importance of these different types when exiting your business.

In the financial statement arena, there are six levels of statements that your CPA can prepare for your business. These statements include:

- CPA-audited financial statements with full footnote disclosures
- CPA-reviewed financial statements with full footnote disclosures
- CPA-compiled financial statements with full footnote disclosures
- CPA- compiled financial statements with no footnote disclosures
- Tax returns
- Internal financial statements

Depending on the type of financial statement you have your CPA create, the statement can provide a varying degree of reliance and reputability for potential buyers. The créme de la créme of reporting standards is CPA-audited financial statements with full footnote disclosures. In this instance, a CPA is issuing an opinion as to whether or not the financial statements are free of material misstatement. This typically gives potential buyers a higher level of comfort with your numbers and it can provide more of a degree of accuracy to your statements. The footnote disclosures also provide a lot of valuable information that will enable potential buyers to put your company's balance sheet and income statement into a more realistic perspective. This can be advantageous when you are selling to a third party because the more reliance they have on your financial statements, the less risk they are taking and the more likely they are to pay more for your company.

The cost of audited financial statements varies depending on the size of the company, but they tend to be one of the more expensive options because of the in-depth work and analysis that an auditor performs to create a reputable opinion on the financial statements. The auditor not only has to get an understanding of the company's internal controls, but he or she also has to perform testing of detailed transactions and look at the company from a fraud risk perspective.

The next best type of financial statements is reviewed ones with footnote disclosures. At this level, CPAs do not issue an opinion on the statements, but they state whether they know about any material adjustments that need to be made so the statements comply with the standard of accounting they are using — either U.S. Generally Accepted Accounting Principles (GAAP) or Other Comprehensive Basis of Accounting (OCBOA) such as cash basis, modified cash basis, income tax basis or a prescribed format. In a review engagement, CPAs look at the financial statements from more of an analytical perspective. They also review statement trends, such as how the company performed compared to last year, what the company's budgetary activity looked like for the year and how the industry fared as a whole. Since CPAs don't do as much detailed transaction testing, but rather mostly look for outliers and things that aren't following the trends they expect, review statements can be considerably less expensive than audited ones.

The third option of financial statements is compiled ones either with or without footnotes. In this instance, you turn your books and records over to a CPA and he or she simply takes the information and puts it into the form of financial statements. The cost of these statements can be relatively low, but the statements do not provide potential buyers with a high level of reliance or assurance.

The last level of financial statements is tax returns and internal financial statements. Both of these scenarios are low cost, but they also typically provide the lowest level of accountability for potential buyers.

So, what type of financial statements do you need if you plan on selling your business to an outside third party? In the years leading up to selling the business, most owners don't want to pay for audited financial statements because of the high costs. During this time, you should talk with you're Exit Planning Advisor so that you can establish the groundwork for creating an exit path that meets your exit objectives. An important part of establishing this groundwork is having your CPA maintain clean and consistent records from year to year so that if you do end up needing audited statements for banking, financial or business transfer purposes, it will be easier for a CPA firm to create the audited documents when the time is appropriate.

As a result, the type of financial statements that you will need for your business exit will be dependent on not only the size of your company, but also on whether you are planning to sell to a sophisticated third-party buyer. If your company is worth less than $1 million and you want to sell to a company of similar size and nature, then you may only need compiled financial statements, which can cost many times less than audited statements.

However, if your company is more highly valued and you plan to sell to a larger, more sophisticated buyer, then it is more than likely that the potential buyer will insist upon audited financial statements. Even though the cost of audited statements can be higher than the other options, they can put you in a better position in this type of situation to receive a better price for your company and execute a successful exit. The bottom line is that it's important to talk with your Exit Planning Advisor to determine which scenario is best for your situation.

If you have any questions about the different types of financial statements discussed in this article and how they fit within your exit plan, please contact us to discuss your particular situation.

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